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FIVE KEYS TO RISK AND RISK MANAGEMENT

As a fiduciary, it's your duty to monitor risk — are you prepared?

Risk is the 800-pound gorilla of investing. You can't ignore it. At the same time, it sometimes feels too big to handle. Unfortunately,

fiduciaries don't have a choice. Duties of loyalty and care necessitate the creation and implementation of a system to identify, measure, and manage risk. The consequences of inaction or sloppiness are weighty and may include regulatory sanctions, litigation, harm to reputation, higher fiduciary insurance costs, plan losses and personal penalties. Even when the asset allocation and money management functions are delegated to others, fiduciaries bear a duty to monitor.

For many plans, this kind of undertaking is a big deal and can be summarized with the Five C Approach to Risk Management as shown below. First and foremost, someone at the top must commit to a management style based on best practices that go well beyond what is minimally necessary for compliance purposes. The goal is to align compensation with what constitutes prudent and appropriate risk taking and to make sure that staff, systems and training are adequate. The last thing anyone wants is a rogue trader who is perversely rewarded for introducing too much leverage by taking short positions, using derivatives in a speculative fashion, or inappropriately investing in complex securities. Computer meltdowns can be just as bad.

Second, plan fiduciaries must comprehend enough about investment and risk management principles such as diversification, hedging and portable alpha to evalu-

ate competing strategies. Can the plan fiduciaries pass a simple investments quiz? Do they know anything about derivatives? How are they selected and for what duration? Do their backgrounds reflect relevant experiences and knowledge?

Third, technology (computer) infrastructure must support data collection and analysis. This is more than a trivial pursuit, particularly when outside firms submit performance numbers in different ways, making it hard to evaluate reports on an "apples to apples" basis. Data quality is equally important. Are there in-house analysts or outside experts who understand data quality issues and their impact on asset-liability management?

Fourth, effective risk management is impossible without internal controls that provide checks and

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balances throughout the organization to prevent fraud and minimize loss. This may be as elementary as separating the settlement and trading functions or it could entail a step-by-step approach to assess model risk and make changes accordingly. Policies and procedures should be clearly spelled out by independent parties who will not directly benefit from their recommendations.

Finally, communicating results gives management a chance to take a bow, empower employees, and convey a message about diligence that speaks volumes. It's not a matter of finding the perfect solution. There is no "one size fits all" approach to risk management. Each plan is unique by virtue of its design, demographics, funding status, sponsor constraints and regulatory mandates. Process is everything and must start with a fiduciary push to keep promises. ■

THE FIVE C APPROACH TO RISK MANAGEMENT

- Commitment
- Comprehension
- Computers
- Controls
- Communications